

Arthur Andersen
Professional Standards Group

To: Carl E. Bass@ANDERSEN WO
cc: Benjamin S. Neuhausen@ANDERSEN WO
Date: 12/18/99 09:31 AM
From: John E. Stewart, Chicago 33 W. Monroe, 50 / 72335
Subject: Re: Enron Option

Thanks for the memo. Very clear and I agree with your advice. Lets wait until Monday. The original accounting was probably aggressive even though it was consistent with our 1986 book. The book clearly says the that this accounting is for hedges of things carried at market. Otherwise, options are at real fair value. That book was written in another era and time has probably passed it by, but clearly after the stock was sold, one needs to revert to regular mark to fair value(both time and intrinsic value) and derivatives cannot hedge derivatives for accounting purposes—now or under FASB 133. Does Dave think his accounting works even under FASB 133? No way.

To: John E. Stewart@ANDERSEN WO
cc:
Date: 12/18/99 08:24 AM
From: Carl E. Bass, Houston, 237 / 2314
Subject: Enron Option

It may be easier to put this in writing. Dave Duncan called me after I left the Octel to you yesterday that he had already spoken to Mike Odom, the Houston office Practice Director and that they "made a practice call."

Background

About three weeks ago I got a call from Clint Carlin regarding a proposed Enron transaction to sell a marketable security that they are accounting for at fair value. They are not applying Statement 115 using the trading classification, rather they are applying fair value under investment company accounting. There are some options that they entered into with this SPE managed by the company's CFO. Initially they were going to sell the security and the options and the initial question was can the options be included. I said yes they fall under Statement 125 since they are financial assets. Clint came back and said that there was a problem because there was a difference between the carrying amount of the options and what they would receive. That is when I found that they had applied our guidance in Accounting for Options. That is they bifurcated the option between the time value and the intrinsic value and amortized the time value over 5-10 years, depending on the particular option. Our guidance clearly accepts this even for a fair value investment. So I told them that they needed to account for the difference (ie through P&L) when they sold the options and the stock compared to the proceeds received which presumably would be at fair value. I did not hear from them again until last Thursday.

They asked another question. During the course of the call I inquired about the options. I was told that the options were not included in the sale. I told them that if they sold the underlying and now had a naked option and would need to get its carrying value to fair value for the entire option (both intrinsic value and time value) and that the charge should go through P&L.

Dave Duncan called me yesterday and said that he had never understood the bifurcation approach in our book to be hedge accounting. Rather he believed it was just another way to account for fair value. So in

his mind he had two instrument that were being accounted for at fair value. I told him that hedge accounting was the only way to get that bifurcated approach and once the hedged item was sold, there was some accounting to do. I told him that we do not accept hedge accounting for a derivative by another derivative (as part of the Statement 125 transaction they apparently took back a total return swap) and in any event it would be inappropriate to carry forward a hedge on one asset (the marketable security) to another instrument (the total return swap). He told me that the charge here would be \$30-50 million. He said that the deal had either been signed or was about to be signed and that we could not go back now. I stated that our advice was consistent and timely on this. He said that he was not clear that the original bifurcated approach he had discussed with was limited to hedging despite the language in our book, which I pointed out to him.

I also spoke with Ben to see if there was anything else Ben could think of to help them out and Ben had no other thoughts.

My concerns

We raised the issue. I have not spoken to the Practice Director. I do not know if he knows how much we cannot support this. Where do we go from here? This is a big item and the team apparently does not want to go back to the client on this. I think at a minimum the Practice Director needs to be made aware of this history and our opposition to the accounting. I guess this call on Monday is to see if there is some way we can find that can accept this but I am out of ideas.

If you want to talk about this today let me know. Otherwise it can wait till Monday. The deal has been done apparently.

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John E. Stewart